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April 22, 1994

Mr. William F. Caton, Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: Ex Parte Submission in Gen. Docket No. 90-314; "Errors in Hazlett's Analysis of Cellular Rents: An Elaboration"

Dear Mr. Caton:

In August of last year, Time Warner Telecommunications commissioned and introduced into the record in this proceeding a 31-page study by Thomas Hazlett entitled "Market Power in the Cellular Duopoly." In September of last year, Dr. John Haring and Dr. Charles Jackson submitted to the Commission a brief rebuttal of the Hazlett piece, "Errors in Hazlett's Analysis of Cellular Rents." In January of this year, Dr. Hazlett presented a 43-page response to the Haring/Jackson filing, "Errors in the Haring & Jackson Analysis of Cellular Rents."

Attached is a brief reply by Drs. Haring and Jackson to the latest Hazlett submission. It summarizes the differences between the Hazlett and the Haring/Jackson analyses in a self-described effort to "'stop the killing' (of trees)". Regarding policy implications, the paper concludes:

Bell Atlantic has proposed that incumbent cellular firms each be allowed to bid on 20 MHz of PCS spectrum in the FCC's auction. Under the Bell Atlantic proposal, between two and four new firms could be expected to enter each cellular market (assuming cellular operators win the maximum authorized spectrum, which they may not). The advantage of making additional spectrum available to incumbents is that they are potentially efficient users of that spectrum. In our previous response, we reasoned that, since the supply of wireless telecommunications services is going to increase sharply, the Bell Atlantic proposal would not likely cause competitive harm and could be procompetitive. Hazlett's analysis lends no insight regarding this issue.

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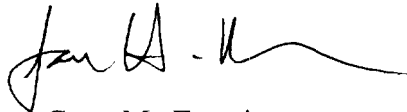
April 22, 1993

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The Haring/Jackson reply also concludes that Hazlett "still has not proven that the cellular industry exercises market power"; that the Hazlett analysis "does not support" Time Warner's policy recommendations; and that the Time-Warner view "apparently favors a world with fewer real competitors."

Thank you for your consideration. Please contact us if you have any questions regarding this submission.

Very truly yours,

A handwritten signature in black ink, appearing to read "Gary M. Epstein", with a long horizontal flourish extending to the right.

Gary M. Epstein
James H. Barker
of LATHAM & WATKINS

Counsel for Bell Atlantic
Personal Communications, Inc.

Enclosure

STRATEGIC
POLICY
RESEARCH



**ERRORS IN HAZLETT'S
ANALYSIS OF CELLULAR RENTS**
An Elaboration

**John Haring
Charles L. Jackson**

ERRORS IN HAZLETT'S
ANALYSIS OF CELLULAR RENTS:

AN ELABORATION

JOHN HARING

AND

CHARLES L. JACKSON

APRIL 8, 1994

**ERRORS IN HAZLETT'S
ANALYSIS OF CELLULAR RENTS:
AN ELABORATION**

**JOHN HARING
AND
CHARLES L. JACKSON¹**

I. Introduction

Thomas W. Hazlett, Ph.D., has produced a 43-page response to our 9-page comment on his 31-page paper.² Hazlett's forestry management program has produced mostly smoke. In an attempt to "stop the killing" (of trees), we offer a brief response outlining our differences.

II. Theory

Hazlett is in deep denial about his seeming adoption of the Bertrand (*i.e.*, price) variant of the Cournot model. This is not a matter of import in terms of our critique. We leave the reader to decide what variant of Cournot he was actually, if inadvertently, describing.³ Hazlett now claims (page 4) that "the Cournot model defines a seemingly more realistic situation than that suggested by the 'Bertrand paradox'." Remark two points: (1) in terms of behavioral realism, the Bertrand variant, while subject to many of the same shortcomings of

¹ The authors are principals in Strategic Policy Research, Inc., an economics and telecommunications policy consulting firm located in Bethesda, Maryland. Haring formerly served as Chief Economist and Chief, Office of Plans and Policy, at the Federal Communications Commission. Jackson was formerly the Staff Engineer with the House Telecommunications Subcommittee and engineering assistant to FCC Commissioner Glen O. Robinson.

²See Hazlett, *Market Power in the Cellular Telephone Duopoly*, August 1993, Haring and Jackson, *Errors in Hazlett's Analysis of Cellular Rents* (September 10, 1993) and Hazlett, *Errors in the Haring & Jackson Analysis of Cellular Rents* (January 1994).

³Similarly, the Commission can easily verify Kwerel and Williamson's motivation in utilizing Cournot reasoning in their OPP Working Paper to synthesize the price effects of an expansion of supply in the absence of an economic model of supply and demand and, in particular, a demand elasticity.

the quantity variant and itself highly abstract, provides a more realistic description of how firms actually behave (*i.e.*, with a focus on price rivalry) than the quantity variant;⁴ and (2) in terms of predictive accuracy, far from defining a “seemingly more realistic situation,” our view is that the quantity variant is generally inferior to the price variant. Moreover, in the instant setting, it is not the models’ realism in either sense, but the reality of the situation defined that is precisely what is at issue. Hazlett continues to employ circular reasoning; he continues to assume rather than prove what he has assumed the burden of proving.

To comprehend Hazlett’s logical error, consider an illustrative analogy. In evaluating a claim of unreasonable price discrimination, the Commission may seek to account for price differences by determining whether like services are provided. Were the Commission to base a finding that like services were *not* being offered on the existence of price differences, the Courts would likely reject (and, indeed, have rejected) such a finding as based in circular reasoning. It is not compelling to argue that price differences are reasonable because products differ when the gauge of product differences is price differences. Hazlett is, in our view, similarly trying to eat his cake and still have it.

Hazlett contends that he can prove that cellular firms earn monopoly rents. What is his proof? He argues that the industry is a duopoly (*pace* telco, PCS, ESMRS, *etc.*) and conjectures that firms behave in a Cournot fashion. How does he know that the industry actually behaves à la Cournot? Easy — reasoning circularly, the industry allegedly earns monopoly rents.

Far be it from us to constrain Brother Hazlett’s selection of poison. If he wants to hoist himself on a petard by Cournot, that is his business. We do object to his attempt, in striking that pose, to saddle us with burdens that are not ours to bear. Hazlett (page 30) claims that our burden is the same as his. That is not so. We are not advocating restrictions on the number of PCS licenses or license eligibility (as has Hazlett’s Time Warner client). We are not advocating heavy-handed regulation of cellular firms (as apparently is Hazlett’s current client). Hazlett seems to believe that the presumption is that regulation is warranted unless we can prove it is not. We believe the burden is his to show that regulatory restrictions are warranted and that he has failed to meet that burden.

⁴Prices are generally more easily monitored than quantities.

Hazlett claims we are drawing a “silly,” “semantic” distinction in contrasting cable’s genuine monopoly power with the absence of monopoly, *per se*, in cellular. That distinction is not only theoretically valid, but it is of critical significance in terms of Hazlett’s argument. The theory of monopoly *does* yield determinate results — monopolists restrict output. It is thus perfectly valid to infer that some portion of rents earned by cable monopolists reflects the exercise of monopoly power. Hazlett and we agree that results under oligopoly are *indeterminate*. Hazlett claims that cellular rents reflect oligopolistic behavior, but that depends on what kind of oligopolistic behavior is assumed and the defensibility of that assumption. This is a case where the ends are not allowed to justify the means because the means are already being used to justify the ends. In our comment, we emphasized the importance of behavioral evidence of output restriction (*e.g.*, evidence of collusion) as a way of breaking this circularity. Hazlett’s response is that Cournot players do not need to collude. They do, however, need to prove they exist by reference to something other than their alleged outward manifestation.

III. Interpretation of Rents

Hazlett has us leading Jerry Hausman down a cul-de-sac. Hausman is an MIT Professor and a winner of the John Bates Clark Medal, one of the two most prestigious prizes awarded by the American Economic Association for professional merit. The idea that we are taking Hausman any place he does not wish to go is ludicrous, as anyone who knows Hausman will attest. Rather than Hausman taking a wrong turn, we think this is simply a matter of Hazlett being wrong.

The concept of “economic rent” was originally developed by the English economist, David Ricardo (1772-1823). The concept is most easily applied to land. Land already exists; so there are no costs of production. Nevertheless, if land were leased at a price of zero, there would be excess demand and markets would not clear. Consequently, leases of land are at a positive price and lessors of land receive positive revenues. These revenues are called “economic rent.” Land rents exist even when the landowner has no market power. Monopoly rents can also be illustrated in this context. Suppose that a single person owns all the land suitable for a particular purpose. The owner can, by withholding some land from the market,

increase revenues. The additional revenues — over and above those earned at the market-clearing price — are monopoly rents. Such rents can be earned only if the landowner has market power.

The distinction between economic rents and monopoly rents is critical for policy analysis. Monopoly rents can be reduced or eliminated by increasing the number of sellers. Economic rents, however, cannot be reduced that way. The existence of monopoly rents implies potential public benefits from increasing the number of sellers, although losses of scale and scope economies must be weighed against these potential benefits. The existence of economic rents carries no such implication; it implies that there are potential benefits from relieving the scarcity of the resource.

The concept of economic rents can be applied to the cellular industry in a straightforward manner: Suppose that the cellular industry, now or at some time in the future, priced at average cost and imputed no rents to the cellular spectrum. Would there be excess demand that the cellular companies could not handle (without increasing average cost) because of spectrum limitations? If so, economic rents must be imputed to the cellular spectrum. Those rents would be earned, irrespective of how competitive or non-competitive the cellular industry might be.

The magnitude of economic rents is defined by the following thought experiment: Suppose that the cellular industry always priced at average cost, including imputed rents for the use of spectrum. How large would those rents have to be in order to clear the market? At the market-clearing rent level, there would be no excess demand that could not be handled because of spectrum limitations. The level of rents defined by this thought experiment would be earned irrespective of how competitive the cellular industry might be.

The cellular industry may, of course, earn rents that exceed economic rents, as defined above. Such rents could derive from good management or good luck. Alternatively, they might derive from market power. Hazlett's treatment of economic versus monopoly rents is based on a specious argument. He reasons that the cellular licensee does not "own" the cellular spectrum. The licensee is only licensed to use the spectrum.⁵ Consequently, any

⁵Hazlett (page 14) says "cellular firms may 'control' their license, but the use of the spectrum is controlled by the FCC."

rents that are earned are monopoly rents. This is like saying that, since God owns all the land and men and women are only stewards of it, all rents earned on land are monopoly rents — not economic rents. That conclusion is wrong, since the landholder would generally not have market power in the market for land. Economic rents do not hinge on Hazlett's metaphysical concept of "ownership." Rather they derive from the economic condition of scarcity of the resource-spectrum.⁶

Hazlett reasons that cellular firms "own" only a piece of paper; *viz.*, their spectrum license. Cable companies also own a piece of paper; *viz.*, their franchise. Hazlett claims that such pieces of paper are merely intangible assets, and intangible assets cannot earn economic rents. This argument is incorrect. A cellular license purveys control over a scarce resource. It allows the licensee to earn the economic rents associated with the spectrum. Such rents exist no matter how many firms use the same spectrum to produce substitute services (assuming no dissipation of rents through technical inefficiency). No similar resource constraint applies to cable companies. If a large number of firms provided cable service in the same area, cable's rents would largely disappear. For these reasons, we can conclude that rents earned by cable companies are largely monopoly rents. We are not entitled to make any such inference with regard to cellular firms.

IV. Empirical Evidence

In assessing Hazlett's empirical work, we note where we agree and disagree with him: We acknowledge that the q-ratio of the cellular industry is well above unity and that this reflects market expectations that the cellular industry either earns or will earn substantial rents. Unlike Hazlett, we believe that a substantial part (though not necessarily all) of these anticipated rents are economic rents — not monopoly rents. Hazlett's analysis does not prove that the cellular industry exercises market power. He has shown only that anticipated rents are large; he has not shown that *monopoly* rents are large.

⁶In this regard, Hazlett's discussion of the "sunk cost fallacy" is simply semantic legerdemain. In reality, economic rents are earned by scarce resources, no matter how competitive the market. They do not disappear even though Hazlett names them "sunk costs." The fallacy is Hazlett's analysis.

V. Policy Implications

There is a certain irony about Hazlett's efforts. For the second time, he has produced an analysis that does not support his client's position. As we pointed out last time, irrespective of (one's views about) *current* competitive conditions and the provenance of cellular rents, there are compelling arguments for a large expansion of supply, and given a large expansion, there is little to lose and potentially something to gain by not restricting license eligibility. This time we note that, were Hazlett right about oligopolistic output restriction, the kind of heavy-handed regulation his client espouses is precisely the wrong policy prescription. It will facilitate collusion rather than discourage it.

Bell Atlantic has proposed that incumbent cellular firms each be allowed to bid on 20 MHz of PCS spectrum in the FCC's auction. Under the Bell Atlantic proposal, between two and four new firms could be expected to enter each cellular market (assuming cellular operators win the maximum authorized spectrum, which they may not). The advantage of making additional spectrum available to incumbents is that they are potentially efficient users of that spectrum. In our previous response, we reasoned that, since the supply of wireless telecommunications services is going to increase sharply, the Bell Atlantic proposal would not likely cause competitive harm and could be procompetitive. Hazlett's analysis lends no insight regarding this issue. He does not address at all the consequences of making spectrum in the 2-GHz range available to mobile firms currently operating at 800 MHz. He has apparently not considered the competitive implications of ESMRS.

VI. Conclusion

Hazlett still has not proven that the cellular industry exercises market power and his analysis does not support his clients' policy recommendations. We observe that Hazlett's Time Warner client appears to be engaging in the competition-suppressing and rent-seeking behavior that he disparages. In particular, Time-Warner apparently favors a world with fewer real competitors while we argue for a world with more competitors and, we believe, stronger competition that will better serve the public.